# In the Supreme Court

OF THE

# United States

OCTOBER TERM, 1947

**No. 224**

JAMES F. WATERS, INC. (a corporation),
*Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

## PETITIONER'S REPLY TO BRIEF FOR RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI to the United States Circuit Court of Appeals for the Ninth Circuit.

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## PETITIONER'S REPLY TO BRIEF FOR RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI to the United States Circuit Court of Appeals for the Ninth Circuit.

### I. CONGRESS CANNOT DEPRIVE PETITIONER OF ALL RECOURSE TO ALL COURTS ON ALL QUESTIONS ARISING UNDER 721 I.R.C.

It is crystal clear that Congress has attempted to deprive *all courts* of *all* review of *all* questions under Section 721.[1]

[1]Internal Revenue Code Section 732(c). It is so stated by respondent (Brief, p. 4).

The question is whether Congress has the power to so do.

The proper disposition of the controversy as to the amount of petitioner's tax under Section 721 is the exercise of judicial power.

This Court has made that clear in *Old Colony etc. v. Commissioner* (1929), 279 U.S. 716, where in speaking of the power of the Circuit Court of Appeals to review a decision of the Board of Tax Appeals (now the Tax Court) it said in no unmistakable terms:

> "In the case we have here, there are adverse parties. The United States or its authorized official asserts its right to the payment by a taxpayer of a tax due from him to the Government, and the taxpayer is resisting that payment or is seeking to recover what he has already paid as taxes when by law they were not properly due. That makes a case or controversy, and *the proper disposition of it is the exercise of judicial power.* * * * *The subject matter of the controversy is the amount of the tax claimed to be due or refundable and its validity, and the judgment to be rendered is a judicial judgment.*"

It is simple. The Circuit Court of Appeals in reviewing the decisions of the Tax Court in the every day run of the mill case does exercise the judicial power of the United States.

The plain mandate of the Constitution (Article III, Section 1) vests that power in the courts, not in executive administrative agencies such as the Tax Court.

The judicial power so granted by the Constitution may not be taken away by the Congress. Congress cannot deprive the lowliest citizen of these United States of his right to have administrative error corrected by a court of competent jurisdiction.[2]

Respondent says taxpayer has *NO* right to *any* judicial review of the asserted error by *any* court citing (Res. Br. p. 7) *Williamsport etc. v. United States* (1928), 277 U.S. 551; *Heiner v. Diamond Alkali Co.* (1933), 288 U.S. 502, and *Welch v. Obispo Oil Co.* (1937), 301 U.S. 190.

The three cases relied on by respondent involve discretionary powers of the Commissioner. No discretionary power is found in Section 721.[3] Therefore the three cases cited by respondent are not controlling.[4]

Moreover, in the *Williamsport* case this Court said the determination of the Commissioner under Section 327 and 328 could not be challenged in the courts "in the absence of fraud or other irregularities." We of course do not intimate that either the Commissioner or the Tax Court were guilty of fraud. We assume that this Court used the word "irregularities" in its

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[2]See *Estep v. United States* (Feb. 4, 1946), 327 U.S. 114; *Board etc. v. Agnew* (Jan. 6, 1947), 329 U.S. 441.

[3]Please note that Section 722 is not involved in this case.

[4]Whether these cases are controlling requires an examination of the statutes involved and to some extent the cases themselves. We have thought the simplest way to keep this brief concise (Sup. Ct. Rule 38) is to eliminate this detail here, but to include it in the appendix hereto for the convenience of the reader should he desire further enlightenment.

ordinary every day sense.[5] According to Webster "irregularity" is the state of being irregular. He defines "irregular" as "not according to established law." It is our position that neither the determination of the Commissioner nor of the Tax Court was "according to established law," i.e., Section 721.

It is a simple, fundamental right which we seek from this great Court. This application should be granted not merely for this taxpayer, for it can survive the administrative error, but to protect the liberties of our people from administrative error assertedly not subject to any judicial correction no matter how flagrant the error.

So far as our research has shown, this is the first time in any revenue law that the Congress has expressly sought to prevent a taxpayer of all recourse to all courts on all questions under a particular section. This Court should use its simple but fundamental power to keep our government a government of laws and not of men, for there is no liberty if the judicial power is not separated from the executive power lest the executive behave with oppression.[6]

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[5]*Crane v. Commissioner* (Apr. 14, 1947), 330 U.S. .....; and footnote 13 therein.

[6]Montesquieu, The Spirit of the Laws, Book 11, Ch. 6.

## II. THE EXCLUSION OF THE PROCEEDS OF THE LIFE INSURANCE POLICIES FROM GROSS INCOME IS NOT LIMITED BY SECTION 22(b)(2) I.R.C.

This subject was concisely discussed in our brief in support of the petition (pp. 38-45). Our only reason for adverting to this subject here is that respondent[7] has quoted from the Senate Committee Report. The language of that report lends some weight to respondent's argument but we are not at liberty to refer to Committee reports when there can be no doubt of the meaning of the words used.[8]

Respondent omits all reference to the later conference report which, *ex industria,* changed the language of the Senate report and not only eliminated the language relied upon by respondent but recast the language to speak of a corporation acquiring a life insurance policy instead of one transferring a policy. The conference report plainly states:

> "Where a corporation acquires a life insurance policy from a predecessor corporation in a tax-free reorganization, proceeds received under the policy will be exempt from taxation."

That is exactly this case.

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[7]Brief, p. 8.
[8]*Helvering v. City Bank* (1935), 296 U.S. 85.

## CONCLUSION.

We urge this Court to grant *certiorari* so that the questions may be determined on their merits regardless of the ultimate success of either party. The elimination of all judicial review of an administrative agency regardless of whether there is abuse of discretion or reasonable basis to sustain the determination of the administrative agency and no matter how flagrant the violation of the statute, should not be tolerated by this Court. That is what Section 732(c) attempts to do.

Dated, San Francisco, California,
September 12, 1947.

Respectfully submitted,
EVERETT S. LAYMAN,
*Attorney for Petitioner.*

**(Appendix Follows.)**

## Appendix

### THE WILLIAMSPORT, DIAMOND ALKALI AND OBISPO OIL CO. CASES ARE NOT CONTROLLING AS THEY ARE BASED ON A DISCRETIONARY POWER OF THE COMMISSIONER WHICH IS NOT FOUND IN THE PROVISIONS OF I.R.C. SECTION 721.

In the *Williamsport* case (277 U.S. 551), there were involved Sections 327 and 328 of the Revenue Act of 1918. We quote from each section here:

> "Sec. 327. That in the following cases the tax shall be determined as provided in section 328:
>
> (a) Where the Commissioner is unable to determine the invested capital as provided in section 326;
>
> * * * * * * *
>
> (c) Where a mixed aggregate of tangible property and intangible property has been paid in for stock or for stock and bonds and the Commissioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds, respectively;
>
> (d) Where upon application by the corporation the Commissioner finds and so declares of record that the tax if determined without benefit of this section would, owing to abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without benefit of this section and the tax computed by reference to the representative corporations specified in section

328. This subdivision shall not apply to any case (1) in which the tax (computed without benefit of this section) is high merely because the corporation earned within the taxable year a high rate of profit upon a normal invested capital, nor (2) in which 50 per centum or more of the gross income of the corporation for the taxable year (computed under section 233 of Title II) consists of gains, profits, commissions, or other income, derived on a cost-plus basis from a government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive."

"Sec. 328. (a) In the cases specified in section 327 the tax shall be the amount which bears the same ratio to the net income of the taxpayer (in excess of the specific exemption of $3,000) for the taxable year, as the average tax of representative corporations engaged in a like or similar trade or business, bears to their average net income (in excess of the specific exemption of $3,000) for such year. * * *

In computing the tax under this section the Commissioner shall compare the taxpayer only with representative corporations whose invested capital can be satisfactorily determined under section 326 and which are, as nearly as may be similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of war profits or excess profits, and all other relevant facts and circumstances.

(b) For the purpose of subdivision (a) the ratios between the average tax and the average net income of representative corporations shall be

determined by the Commissioner in accordance with regulations prescribed by him with the approval of the Secretary.

In cases in which the tax is to be computed under this section, if the tax as computed without the benefit of this section is less than 50 per centum of the net income of the taxpayer, the installments shall in the first instance be computed upon the basis of such tax; but if the tax so computed is 50 per centum or more of the net income, the installment shall in the first instance be computed upon the basis of a tax equal to 50 per centum of the net income. In any case, the actual ratio when ascertained shall be used in determining the correct amount of the tax. If the correct amount of the tax when determined exceeds 50 per centum of the net income, any excess of the correct installments over the amounts actually paid shall on notice and demand be paid together with interest at the rate of ½ of 1 per centum per month on such excess from the time the installment was due."

* * * * * * *

To contrast this language with the present Section 721, we quote therefrom:

"Sec. 721. ABNORMALTIES IN INCOME IN TAXABLE PERIOD.

(a) DEFINITIONS.—For the purposes of this section—

(1) ABNORMAL INCOME.—The term 'abnormal income' means income of any class includible in the gross income of the taxpayer for any taxable year under this subchapter if it is abnormal for

the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 125 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence.

(2) SEPARATE CLASSES OF INCOME.—Each of the following subparagraphs shall be held to describe a separate class of income:

(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

(B) Income constituting an amount payable under a contract the performance of which required more than 12 months; or

(C) Income resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months; or

(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's accounting period or method of accounting; or

(E) In the case of a lessor of real property, income included in gross income for the taxable year by reason of the termination of the lease; or

(F) Income consisting of dividends on stock of foreign corporations, except foreign personal holding companies.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (F), inclusive, shall be subject to regulations prescribed by the Commissioner with the approval of the Secretary.

(3) NET ABNORMAL INCOME.—The term 'net abnormal income' means the amount of the abnormal income less, under regulations prescribed by the Commissioner with the approval of the Secretary, (A) 125 per centum of the average amount of the gross income of the same class determined under paragraph (1), and (B) an amount which bears the same ratio to the amount of any direct costs or expenses, deductible in determining the normal-tax net income of the taxable year, through the expenditure of which such abnormal income was in whole or in part derived as the excess of the amount of such abnormal income over 125 per centum of such average amount bears to the amount of such abnormal income.

(b) AMOUNT ATTRIBUTABLE TO OTHER YEARS. —The amount of the net abnormal income that is attributable to any previous or future taxable year or years shall be determined under regulations prescribed by the Commissioner with the approval of the Secretary. In the case of amounts otherwise attributable to future taxable years, if

the taxpayer either transfers substantially all its properties or distributes any property in complete liquidation, then there shall be attributable to the first taxable year in which such transfer or distribution occurs (or if such year is previous to the taxable year in which the abnormal income is includible in gross income, to such latter taxable year) all amounts so attributable to future taxable years not included in the gross income of a previous taxable year.

(c) COMPUTATION OF TAX FOR CURRENT TAXABLE YEAR.—The tax under this subchapter for the taxable year, in which the whole of such abnormal income would without regard to this section be includible, shall not exceed the sum of:

(1) The tax under this subchapter for such taxable year computed without the inclusion in gross income of the portion of the net abnormal income which is attributable to any other taxable year, and

(2) The aggregate of the increase in the tax under this subchapter for the taxable year (computed under paragraph (1), and for each previous taxable year which would have resulted if, for each previous taxable year to which any portion of such net abnormal income is attributable, an amount equal to such portion had been included in the gross income for such previous taxable year.

* * * * * * *

(e) APPLICATION OF SECTION.—This section shall be applied only for the purpose of computing the tax under this subchapter as provided in subsections (c) and (d), and shall have no effect upon the computation of base period net

income. For the purposes of subsection (c) and (d)—

(1) Net abnormal income means the aggregate of the net abnormal income of all classes for one taxable year.

(2) Under regulations prescribed by the Commissioner with the approval of the Secretary, the tax under this subchapter for previous taxable years shall be computed as if the portions of net abnormal income for each previous taxable year for which the tax was computed under this section were included in the gross income for the other previous taxable years to which such portions were attributable."

* * * * * * *

This section is far more comparable to Section 301 of the 1918 Act from which we quote:

"Sec. 301. TAX RATES.—(a) That in lieu of the tax imposed by Title II of the Revenue Act of 1917, but in addition to the other taxes imposed by this Act, there shall be levied, collected, and paid for the taxable year 1918 upon the net income of every corporation a tax equal to the sum of the following:

First Bracket.

30 per centum of the amount of the net income in excess of the excess-profits credit (determined under section 312) and not in excess of 20 per centum of the invested capital;

Second Bracket.

65 per centum of the amount of the net income in excess of 20 per centum of the invested capital;

Third Bracket.

The sum, if any, by which 80 per centum of the amount of the net income in excess of the war-profits credit (determined under section 311) exceeds the amount of the tax computed under the first and second brackets.

(b) For the taxable year 1919 and each taxable year thereafter there shall be levied, collected, and paid upon the net income of every corporation (except corporations taxable under subdivision (c) of this section) a tax equal to the sum of the following:

First Bracket.

20 per centum of the amount of the net income in excess of the excess-profits credit (determined under section 312) and not in excess of 20 per centum of the invested capital;

Second Bracket.

40 per centum of the amount of the net income in excess of 20 per centum of the invested capital.

(c) For the taxable year 1919 and each taxable year thereafter there shall be levied, collected, and paid upon the net income of every corporation which derives in such year a net income of more than $10,000 from any Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, a tax equal to the sum of the following:

(1) Such a portion of a tax computed at the rates specified in subdivision (a) as the part of the net income attributable to such Government contract or contracts bears to the entire net in-

come. In computing such tax the excess-profits credit and the war-profits credit applicable to the taxable year shall be used;

(2) Such a portion of a tax computed at the rates specified in subdivision (b) as the part of the net income not attributable to such Government contract or contracts bears to the entire net income.

For the purpose of determining the part of the net income attributable to such Government contract or contracts, the proper apportionment and allocation of the deductions with respect to gross income derived from such Government contract or contracts and from other sources, respectively, shall be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary."

* * * * * * *

From the quotations just above, it is plain that Sections 327 and 328 of the 1918 Act are quite different both from the language in Section 721, which is now before this Court, and from the language of Section 301 of the 1918 Act. Sections 327 and 328 involve discretionary powers; neither 721 I.R.C. nor 301 of the 1918 Act involve any discretion. Speaking of the provisions of Sections 327 and 328 of the Revenue Act of 1918 this Court, in the *Williamsport* case, said:

"Sections 327 and 328 were intended to broaden the powers of relief first conferred by Sec. 210 of the War Revenue Act of 1917, c. 63, 40 Stat. 300, 307. It was 'believed necessary to provide a

special method of determining the tax for those cases in which the ordinary method of assessment would result in grave hardship or serious inequality.' Senate Report, 65th Cong. 3d Sess., No. 617, p. 14. The special assessment is to be made under paragraph (a) when the Commissioner 'is unable to determine the invested capital.' It is to be made under paragraph (d) if he 'finds and so declares of record that the tax if determined without the benefit of this section would * * * work * * * an exceptional hardship * * *.' The task imposed on the Commissioner by Section 327 and 328 was one that could only be performed by an official or a body having wide knowledge and experience with the class of problems concerned. For the requirement of a special assessment under paragraph (d) of Sec. 327 and its computation in all cases, are *dependent on 'the average tax of representative corporations engaged in a like or similar trade or business.'*

*"To perform that task, power discretionary in character was necessarily conferred.* Whether, as provided in paragraph (d) of Sec. 327, there are 'abnormal conditions;' whether, because of these conditions, computation under Sec. 301 would work 'exceptional hardship;' whether there would be 'gross disproportion' between the tax computed under Section 301 and 'that computed by reference to the representative corporations specified in section 328;' what are 'representative corporations engaged in a like or similar trade or business;' which corporations are 'as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of busi-

ness transacted and capital employed, the amount and rate of war profits or excess profits, and all other relevant facts and circumstances,'—*these are all questions of administrative discretion.* [Please note that none of these problems are involved under Section 721 in this case.]

"The soundness of the judgment exercised by the individual or body to whom the task was confided would depend largely upon the extent both of the knowledge of the special subject possessed and of the experience had in dealing with this particular class of problems. *The conclusions reached would rest largely upon considerations not entirely susceptible of proof or disproof.* Congress did not, by the Revenue Act of 1918, require the Commissioner to embody the results of his deliberation in findings of fact. The purpose of the meagre record prescribed by Sec. 328(c) in case the Commissioner concludes to order a special assessment is apparently to protect the Treasury, not the taxpayer. For if the Commissioner refuses to make the special assessment, he is not required to state the grounds of his refusal, or, indeed, even to record the fact of such refusal. Thus the aims which induced Congress to enact Sec. 327 and 328, the nature of the task which it confided to the Commissioner, the methods of procedure prescribed, and the language employed to express the conditions under which the special assessment is required, all negative the right to a review of his determination by a court. [No part of this paragraph applies to the language of Section 721.]

"It is true that where the Commissioner's action is reviewable judicially, his findings of fact

in making an assessment, as distinguished from his determination involving administrative discretion, constitute only prima facie evidence; and that, in cases arising under the internal revenue laws, such findings are commonly reviewable by courts in appropriate proceedings in which the facts become an issue. *United States v. Rindskopf,* 105 U.S. 418, 422; *Wickwire v. Reinecke,* 275 U.S. 101, 105 [1 USTC Par. 265]. It is also true that in reviewing the Commissioner's findings on such matters as value, compare *Castner, Curran & Bullitt, Inc. v. Lederer,* 275 Fed. 221; *Little Cahaba Coal Co. v. United States,* 15 F. (2d) 863; allowances for depreciation, compare *Cohen v. Lowe,* 234 Fed. 474; *Camp Bird, Ltd. v. Howbert,* 262 Fed. 114; or the accuracy with which a taxpayer's books reflect his income, compare *In re Sheinman,* 14 F. (2d) 323 [1 USTC Par. 191], courts may be confronted with problems requiring a high degree of technical knowledge for their solution. But such problems involve primarily the situation of a single taxpayer, and the controlling data can easily be made available to the court. [This is certainly true in regard to the case now before this court.] Here, the considerations which demand special assessment under Sec. 327(d), and those which govern its computation in all cases, are facts concerning the situation of a large group of taxpayers which can only be known to an official or a body having wide experience in such matters and ready access to the means of information.

* * * * * * *

"* * * Thus the determinations of the Commissioner in this delicate and complex phase of

revenue administration would be subjected to *review by a large number of courts, none of which have ready access to the information necessary to enable them to arrive at a proper conclusion in revising his decisions;* whose experience in passing upon questions of this character would be limited; and whose varying decisions would tend to *defeat, rather than promote, that equality in the application of the revenue law which Sec. 327 and 328 were designed to insure.* We conclude that the determination whether the taxpayer is entitled to the special assessment was confided by Congress to the Commissioner, and could not, under the Revenue Act of 1918, be challenged in the courts—at least in the absence of fraud or other irregularities." (Emphasis added.)

The *Williamsport* case involved only discretionary powers. In the case now before this Court for decision no discretionary powers are involved; hence the *Williamsport* case is not controlling here.

This Court followed the *Williamsport* case in *Welch v. Obispo Oil Co.* (1937), 301 U.S. 190.

This Court has recognized the distinction between statutes vesting discretionary powers and those prescribing the elements to be used in the computation of a tax. *Heiner v. Diamond Alkali Company* (1933), 288 U.S. 502, supports the result reached by this Court in the *Williamsport* case. In the *Diamond Alkali* case the taxpayer had asked that its excess profits taxes be computed pursuant to Sections 327 and 328 of the 1918 Act. It is true that this case does

follow the *Williamsport* case; it is plain that it does so because of the discretionary powers vested in the Commissioner by Sections 327 and 328 of the 1918 Act. This Court shows in unmistakable language the distinction between Sections 328 and 301 of the 1918 Act in that Section 301 prescribed the elements to be considered and therefore error remained subject to judicial correction while the discretionary powers under Sections 327 and 328 were not subject to judicial control. The following is the language of this Court on this subject:

> "The respondent's tax could only be computed in accordance with Section 301 or under Section 328. The former prescribes the elements to be considered, and error in the computation remains subject to judicial correction; the latter grants the taxpayer the benefit of discretionary action by the Commissioner, and precludes judicial revision or alteration of the computation of the tax."

As we pointed out in our earlier brief (pp. 16-19) Section 301 dealt with income "attributable" to government contracts and income "not attributable" to government contracts. This Court said that section prescribed the elements to be considered and that error in the computation remained subject to judicial correction.

Section 721 deals with income "attributable" to other taxable years. This section like 301 of the 1918 Act prescribes the elements to be considered and as this Court said "error in the computation remains subject to judicial correction."

There is no discretionary power under Section 721. Whether the life insurance proceeds here involved are attributable to other years involve primarily the situation of this taxpayer and no one else, and the controlling data can easily be made available to this Court or any other Court. There are no facts involved in this case concerning the situation of a large group of taxpayers which can only be known to a body having wide experience in such matters and ready access to the means of information.

The action of the Commissioner has tended to defeat rather than promote the application of 721 to every "abnormal item of income" as intended by the Congress.*

*See Ways & Means Committee Report on the 1941 Revenue Act quoted in footnote 10 pp. 20, 21 of petitioner's Brief in Support of Petition for Writ of Certiorari.